COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE EFFECTS OF THE FEDERAL TAX REFORM ACT OF 1986 ON THE RATES OF HAROLD TELEPHONE COMPANY, INC.	)))	CASE NO. 9801

O R D E R

On December 11, 1986, the Commission established this case for the purpose of determining the effects of the Tax Reform Act of 1986 ("Tax Reform Act") on the rates of Harold Telephone Company, Inc. ("Harold"). The Order initially establishing these proceedings was directed to all utilities with revenues in excess of $1 million. The Commission limited its investigations to the major utilities since the impact on smaller privately owned utilities was relatively insignificant. After a review of the initial filings, the Commission disposed of a number of cases due to the minimal impact on rates and the extent of the Commission's regulation of certain competitive telecommunications utilities. At this time, 15 utilities remain under the purview of this examination.

On March 3, 1987, Harold filed testimony and other exhibits in response to the Commission's Order which reflected an increase in annual revenues of $14,207. As a result of the findings and determinations herein, the revenues of Harold will be unchanged by the Tax Reform Act. The overall reduction in revenue requirements for the 15 utilities subject to these proceedings is in excess of $75 million.

Motions to intervene were filed by the Utility and Rate Intervention Division of the Office of the Attorney General ("AG")and Utility Rate Cutters of Kentucky, Inc. ("URC"). All motions to intervene were granted by the Commission.

A public hearing was held at the Commission's offices in Frankfort, Kentucky, on May 1, 1987.

COMMENTARY

In its Order of December 11, 1986, the Commission expressed the opinion that the focus of this proceeding should be reflecting the effects of the Tax Reform Act in rates. Thus, the Commission considered the three primary issues in this matter to be: (1) determining the amount of the revenue change required due to the Tax Reform Act; (2) determining the appropriate date of any rate change; and (3) distributing the revenue change among rate schedules.

The Commission required that a 12-month period ending no more than 90 days from December 11, 1986, the date of the Order establishing this case, should be used to determine the effects of the Tax Reform Act. Harold proposed and the Commission has accepted the 12-month period ending December 31, 1986, as the test period for determining the reasonableness of the proposed rates.

PROCEDURAL ISSUES

Single-Issue Approach

Throughout these proceedings, there have been objections to the methodology used by the Commission in determining the reasonableness of each utility's rates subsequent to the Tax Reform Act. Certain utilities have characterized the Commission's actions as "single-issue" rate-making. Implicit in their objections is the notion that single-issue rate-making is contrary to law.[1]

This notion was rebutted by, among others, Kentucky Utilities Company ("KU"). In his opening argument, in Case No. 9780,[2] counsel for KU stated that this proceeding is soundly based. KU recognized that there was good reason to focus the proceeding on the tax changes.[3] In its post-hearing brief, KU further stated its agreement with the Commission's position that retaining the savings resulting from tax reform was not a proper way for KU to improve its earnings and indicated that a focused proceeding, expeditiously passing the tax savings to ratepayers, was reasonable as long as KU was permitted to maintain its test-period rate of return.[4]

Those complaining of single-issue rate adjustments overlook the Commission's long established practice of adjusting rates for fuel cost charges through Fuel Adjustment Clause ("FAC") and Purchased Gas Adjustment Clause ("PGA") proceedings. Each of

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1 Other states have upheld single-issue rate-making proceedings, see for example, <u>Consumers Power Company</u> v. <u>Michigan Public Service Commission</u>, Mich. App., 237 NW 2d 189 (1975).

2 Case No. 9780, The Effects of the Federal Tax Reform Act of 1986 on the Rates of Kentucky Utilities Company.

3 Hearing Transcript, May 4, 1987, page 9.

4 Brief for KU, filed May 22, 1987, page 4.

these involves setting rates solely on the changes of the cost of coal or natural gas.

Apart from the propriety of single-issue rate-making, however, it must be pointed out that from the outset these cases have never been limited to a single issue. The order of December 11, 1986, did indicate that the Tax Reform Act was the focus of these investigations. However, it stated at page 2:

> If, aside from the Tax Reform Act, a utility feels that its rates are insufficient, it has the discretion by statute to file a full rate case with the Commission. By initiating this case the Commission is in no way prohibiting or restricting any utility from filing a rate case encompassing all rate-making issues in a separate proceeding.

This Order was clarified on January 21, 1987, in Case No. 9799, The Effects of the Federal Tax Reform Act of 1986 on the Rates of Continental Telephone Company ("Continental"). That Order states:

> Because of the breadth of this investigation and the number of parties involved, it is necessary to categorize some information into a consistent, well-defined scope. That scope is explained in the December 11, 1986, Order. The information as it relates to the specific changes occasioned by the Tax Reform Act should be filed as the December 11, 1986, Order requires. The expected effects of those changes on rates should be filed as well. Simply because the Commission deems certain information necessary, and deems it necessary to be filed in a particular format does not preclude the filing of other information a party believes is pertinent.
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> For these reasons, the Commission ORDERS that:
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> (1) All parties shall comply with the December 11, 1986, Order;
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> (2) Any party may file any additional information it deems relevant;
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> (3) Any party may file alternative proposals for the resolution of this investigation.

Thus, there is not, nor has there been, any limitation on any party filing additional information up to and including an adjustment of all rates. The Commission focused its attention primarily on the Tax Reform Act because of the potentially extraordinary impact of this act on the finances and rates of utilities.

Federal income taxes are in one sense an assessment by the federal government on the utilities for their proportionate share of the federal government's budget. Under accepted regulatory rate-making practices, these federal income taxes are included as part of a utility's expenses that are used to establish rates. Thus, through the rate-making process, the utility can be thought of as a collection agent for federal taxes and a conduit through which federal taxes are transferred from ratepayers to the federal government. Because the Tax Reform Act represents such a historic change in federal tax policy, the Commission determined that it was in the best interests of all concerned--utilities and ratepayers alike--to reflect these tax changes in each company's rates as expeditiously as possible. For that reason, the initial concern was the reduction of the corporate tax rate from 46 percent to 34 percent and other relatively minor adjustments caused by the changes in the Federal Tax Code. As we explained in our December 11, 1986, Order:

> First, it would be extremely cumbersome and expensive for the Commission to simultaneously initiate rate cases covering all utilities affected by this Order. Many utilities may not wish to incur the time-consuming and expensive task of preparing a complete rate case at this time. A proceeding that recognizes only the effects of the Tax Reform Act would minimize the time and expense of both the Commission and the utilities.

> Secondly, the Commission does not view retaining the savings that result from tax reform as a proper way for a utility to improve its earnings. Likewise, if the Tax Reform Act should result in major cost increases, these costs should be recognized in rates expeditiously....
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> Finally, by initiating limited cases for every major utility, the expertise of all interested parties can be pooled to assure that all aspects of the Tax Reform Act are fairly reflected in utility rates.

In an effort to fairly reflect only the effects of the Tax Reform Act in the companies' rates, the Commission, to the extent possible, and with the acquiescence of the companies, narrowed the scope of the analysis. All quantifiable aspects of the revenue requirement effects of the Tax Reform Act have been considered, and therefore the rate adjustments ordered herein should have no effect on the utility's earnings.

In summary, the Tax Reform Act is a unique and historic change in tax law that substantially affects the cost of providing utility service. The primary considerations in narrowing the scope of these proceedings were that: (1) the cost change generated by the Tax Reform Act was clearly beyond the control of the utility; (2) the cost change generated by the Tax Reform Act affected all major privately owned utilities in a similar manner; (3) the cost change generated by the Tax Reform Act had a major impact on the cost of service of utilities; and, (4) the cost change generated by the Tax Reform Act was effective at a specified date which was scheduled to occur quickly, requiring expeditious action on the part of the Commission.

For all of the reasons previously stated, the procedure used by the Commission is one that is efficient, reflective of sound regulatory methods, responsive to the substantive and procedural rights of all parties, and consistent with the jurisdiction of the Commission.

Burden of Proof

Several utilities have suggested that the Commission bears the burden of proving the reasonableness of the rates that have been adjusted to reflect the effects of the Tax Reform Act. Continental, for example, cites KRS 278.430. However, this statute refers to appeals of Commission orders to circuit court. It obviously is not applicable to a proceeding before the Commission itself.

In its Order of December 11, 1986, the Commission on its own motion took the extraordinary step of establishing these investigations in response to the historic Tax Reform Act of 1986. There is no statute assigning a burden of proof in this type of special case. KRS 278.250 is particularly noteworthy. After giving the parties a hearing and carefully reviewing the record, the Commission has determined the fair, just, and reasonable rates for each respective utility as prescribed by KRS 278.030. We believe that this procedure is consistent with our statutory responsibilities.

Retroactive Rates

Another issue that has been raised in these proceedings is the possibility of a retroactive change in rates. We have decided that the reduction in each utility's tax rate and the related adjustments will not be reflected in the utility's rates until July 2, 1987. Those rates will be charged for service rendered on and after July 2, 1987. Thus, the rates are entirely prospective, and the issue of retroactivity is moot.

Testimony of URC

The URC filed testimony in each of these cases. However, its witness did not appear at the hearing and was not subject to cross-examination. Several of the parties moved to strike URC's prefiled testimony. After considering the nature of the testimony filed by URC, the Commission will treat it as comment rather than evidence and weigh it accordingly.

DETERMINATION OF THE IMPACT OF THE TAX REFORM ACT

Excess Deferred Taxes

A reduction in the corporate tax rates results in an excess or surplus deferred tax reserve, since deferred taxes resulting from depreciation-related and non-depreciation-related tax timing differences were provided by ratepayers at a higher tax rate than the rate at which they will be flowed back.

On January 1, 1979, the federal corporate income tax rate decreased from 48 to 46 percent. Utilities, in general, flowed back deferred taxes at the new statutory tax rate, which resulted in an excess provision for deferred taxes. The Commission recognized the existence of these excess deferred taxes and in subsequent rate proceedings required that the excess be returned to the ratepayer over a 5-year amortization period.

The change in tax rates under the Tax Reform Act from 46 percent to 34 percent creates a substantial excess provision for deferred taxes. The Tax Reform Act requires that deferred taxes related to depreciation timing differences be flowed back no faster than under the "average-rate assumption method." Under this method an average rate is calculated and, as timing differences reverse, the accumulated deferred taxes are credited to income and the excess deferred taxes are reduced to zero over the remaining life of the property. Moreover, the Tax Reform Act provides that if a regulatory commission requires a more rapid reduction of the excess provision for deferred taxes, book depreciation must be used for tax purposes. The Tax Reform Act does not, however, have specific provisions for the excess deferred taxes that are not related to depreciation. Therefore, the excess deferred taxes have been generally characterized as "protected" (depreciation-related) and "unprotected" (not related to depreciation).

The Commission recognizes the existence of the excess deferred taxes and is of the opinion that these taxes provided by ratepayers in previous years should be returned in an equitable manner. However, the various options for returning these benefits could not be fully explored within the context of this expedited proceeding. Therefore, the issue regarding accelerated amortization of excess deferred taxes will be considered in future general rate proceedings and not in the present, limited proceeding.

The primary position taken by most utilities on this issue was that deferred income taxes should be amortized, as timing differences reverse, using the tax rates in effect at the time they originated or using the average rate assumption method. Therefore, adjustments have been made to insure that deferred taxes resulting from timing differences are returned to ratepayers as required under the Tax Reform Act.

Implementation Date

The Tax Reform Act, which reduces the top corporate tax rate to 34 percent, produces an effective tax rate for 1987 of 40 percent. This is the blended or average rate based on the current tax rate of 46 percent, which is in effect for the first 6 months of 1987, and the 34 percent rate which becomes effective July 1, 1987. The current rates of most utilities are based on the 46 percent tax rate which was in effect at the time the rates were set by the Commission. Therefore, since January 1, 1987, most utilities have charged rates based on a tax rate of 46 percent which is in excess of the 1987 blended rate of 40 percent.

Generally, in order to reflect the effects of the Tax Reform Act during 1987 and beyond, the Commission has two basic options: adjust rates retroactive to January 1, 1987, based on the 1987 blended tax rate of 40 percent and adjust rates January 1, 1988, based on the 34 percent tax rate, or make one adjustment effective July 1, 1987, based on a 34 percent tax rate, to achieve the same overall effect. By this second approach, most companies will have charged rates for the first half of 1987 based on a 46 percent tax rate and for the second half of 1987 based on a 34 percent tax rate. This will result in rates (and tax collections) for 1987 that equate to a blended tax rate of 40 percent.

In response to concerns of some utilities concerning the July 1, 1987, rate change, the Commission cites Section 15 of the Internal Revenue Code of 1986 which prescribes the method of computing taxes in 1987 for calendar year taxpayers. That section requires that "tentative taxes" for 1987 be computed by applying both the 46 percent tax rate and the 34 percent tax rate to taxable income for the entire calendar year; and the tax for the calendar year shall then be the sum of each tentative tax in proportion to the number of days in each 6-month period as compared to the number of days in the entire taxable year.

The Commission is of the opinion that a one-time adjustment, based on a 34 percent tax rate, effective July 2, 1987, will meet the transitional requirements of calendar year 1987 and achieve the Commission's goals for this proceeding as set out in its Order of December 11, 1986.

Revenue Requirements

In its response to the Commission's Order of December 11, 1986, Harold calculated the change in its tax expense as reported for tax purposes. Through subsequent data requests the Commission requested that Harold calculate the effects of the Tax Reform Act on its per books tax expense which would be applicable for rate-making purposes. In response, Harold calculated a reduction to tax expense of $575 based on a tax rate of 34 percent. In addition to the tax rate reduction, this calculation reflected the loss of Investment Tax Credits and the flow back of excess deferred taxes. Due to the de minimis nature of the change in tax expense, Harold requested that no change in rates be made as a result of the Tax Reform Act.

The Commission is of the opinion that the reduction in Harold's tax expense is immaterial and cannot be reflected in rates in an equitable manner. Therefore, the Commission will grant Harold's request that no adjustment be made to its rates as a result of the Tax Reform Act.

Contributions in Aid of Construction and Customer Advances

The Tax Reform Act requires that any contributions received in aid of construction, or any other contribution by a customer or potential customer, to provide, or encourage the provision of services to or for the benefit of the transferor be included as taxable income.[5] On December 12, 1986, Kentucky-American Water Company ("Kentucky-American") submitted a letter to the Commission wherein it proposed the following options for treatment of contributions and customer advances for construction:

a. "No Refund" Option: Under this alternative the contributor would not be entitled to any potential refunds. The total amount contributed would be recorded as ordinary income for tax purposes and the associated tax would be recorded as a payable. Kentucky-American would supply the capital necessary for completion of the construction (construction cost - net contributions).

5 Explanation of Tax Reform Act of 1986. Commerce Clearing House, Inc., par. 1,670, page 486.

b. "Refund" Option: Under this alternative the contributor would be entitled to the potential refund. The contribution would be increased to include federal income taxes and the total amount received would be recorded as ordinary income for tax purposes. The contributor would then be entitled to the potential refund of the entire contribution within the statutory time limit of 10 years.

Further, Kentucky-American proposed that for contributions in aid of construction the no refund option be used for rate-making purposes.

After careful consideration of the information presented by Kentucky-American, the Commission is of the opinion that the refund option as proposed by Kentucky-American appears to be the most equitable method of passing on the taxes related to contributions to both the utility and its general body of ratepayers, in that it will require the customers receiving the service to pay for the total cost of providing that service with the potential for future refunding. Further, the utility and its general body of ratepayers would be only obligated to contribute capital in the future as customers are added to the system and the benefits from those additions are received. Therefore, the Commission has chosen the refund option for use by Kentucky-American and for general applicability to all utilities.

The Commission recognizes that this policy is being established based solely on the evidence presented by Kentucky-American and is of the opinion that this matter should be investigated further in a separate proceeding. Therefore, the policy is being implemented on a temporary basis subject to the outcome of a formal investigation wherein all parties will be given the opportunity to submit evidence on this issue.

The treatment of contributions established herein will result in no revenue requirement impact on the utilities in these proceedings and, thus, no adjustment has been recognized.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. No adjustment in rates is required for Harold as a result of the Tax Reform Act.

2. The rates of Harold in effect under authority of the Commission prior to the date of this Order shall continue in effect.

IT IS THEREFORE ORDERED that Harold's current rates shall not be adjusted and shall remain in effect under authority of the Commission.

Done at Frankfort, Kentucky, this 11th day of June, 1987.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director